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- (a) Annual increase in RPI to previous June.
 - (b) The required reduction in prices for the year commencing August 1, 1996 will be based on the RPI movement for the twelve months to June 1996, which is expected to be announced in mid July 1996. The RPI movement for the twelve months to May 1996 was 2.2%.
 - (c) After permitted carry forward of any unused allowance or shortfall from previous years.
 - (d) After adjustment for a shortfall in directory assistance revenue in the years commencing August 1, 1990 and 1991.
 - (e) The excess price reduction of 0.44% will count towards the required reduction in prices for the year commencing August 1, 1996.
 - (f) Price changes for the year commencing August 1, 1996 not yet determined.

In February 1996, BT agreed License modifications which abolished the previous RPI plus 2 cap on exchange line rentals and ended BT's entitlement to access deficit contributions from other operators, while exchange line rentals continue to form part of the RPI minus 7.5 price cap. The methodology employed to demonstrate compliance with the price cap was also changed to recognize the range of price packages available. The License changes were designed to be financially neutral to the end of the present price cap in July 1997.

For a discussion of the effect of price controls on the Company's financial performance, see "Item 9 — Management's Discussion and Analysis".

Private circuits

From August 1, 1989, a separate price control, fixed at RPI minus 0, applied to prices for UK private circuits. Prices for international private circuits became subject to this control on August 1, 1991. Under the current price control for private circuits (which is effective from August 1, 1993 through July 31, 1997), there are three separate private circuit baskets: national analogue circuits; national digital circuits; and international circuits. Each basket has a price control formula of RPI minus 0, with separate sub-controls of RPI plus 2 on any analogue circuit and RPI plus 1 on any digital circuit.

The Company estimates that the private circuit formula applied to approximately 7% of BT's total operating revenues in fiscal 1996.

Price changes

Overall BT's main prices continue to fall in real terms as a result of BT's obligations to keep changes in the prices covered by the public switched telephony services formula to 7.5 percentage points below the annual movement in the RPI. A number of significant price changes have been introduced during the current price control year which runs from August 1, 1995 to July 31, 1996:

- From October 1995, BT introduced an extra discount of 5% on calls made by business customers to nominated numbers.
- Improved residential discounts were introduced from April 1996.
- Discounts on regional, national and international calls made by business customers were increased by 10% from July 1996.
- From July 1996, standard line rental charges were increased by 3.7% for residential customers and 2.4% for business customers.

Pricing of telecommunications services from 1997

In June 1996, the Director General published a statement on "Pricing of Telecommunications Services from 1997" which set out the proposed scope and scale of price controls on BT after July 1997 when the current price control arrangements end. The document covered both retail and network price controls but full details of the network price controls were deferred until later in 1996 to allow for further discussion.

For public switched telephony, the Director General proposes that a new retail price control, which would operate from August 1997 to July 2001, of RPI minus 4.5 should apply to the first 80% of residential customers by bill size. Retail prices to the business market and to the top 20% of residential customers by bill size would no longer be subject to a price cap after July 1997. However, BT would be required to offer an assurance that a normal residential bill will (for the same level of usage) not increase by more than RPI and that a "control" price package will be made available to business customers. The "control" package for business customers would provide call charges, which will be no higher

than the prices used for calculating adherence to the residential price control and line rental increases should be no more than the increase in RPI. BT would be free to offer other packages to business customers with prices which were lower than the "control" package prices. See "Item 9 — Management's Discussion and Analysis — Introduction — Regulation".

For inland private circuits, the Director General proposes caps of RPI minus 0 on analogue circuits and on digital circuits with limited capacity. There will be no other price controls on other inland private circuits. For international private leased circuits the Director General's proposal is to operate a cap of RPI minus 0 on each individual route.

These proposed retail price controls are dependent upon BT accepting the Director General's proposals for a new License condition on anti-competitive behaviour. See "Regulation — Fair trading in telecommunications".

It is expected that final proposals will be made by the Director General later in July 1996 and agreement sought by him in late July 1996. If BT decides not to agree to the Director General's proposals, the issue is likely to be referred to the MMC.

As regards network price controls, the Director General has proposed a network price control formula of RPI minus X for those services which he believes are not competitive, with the value of X to be proposed by him at a later date. Services which he expects to become competitive, during the price control period, will be subject to caps of RPI minus 0. The Director General has indicated that further discussion is needed with the industry before setting the basis for the network caps in early 1997 but that the new arrangements are still planned to be implemented by August 1997. If BT does not accept the new arrangements for network controls, then the issue is likely to be referred to the MMC.

Relationship with HM Government

HM Government's interest in BT

HM Government holds approximately 0.5% of the outstanding Ordinary Shares. Under the share bonus arrangements made under the UK public offer in July 1993, most of these Ordinary Shares will be transferred from HM Government in August 1996 to eligible individuals who purchased shares in the July 1993 offer and continue to hold them until July 31, 1996.

HM Government continues to hold the special rights redeemable preference share of £1 par value in the Company (the "Special Share"), which is redeemable at par at the holder's option. HM Government has stated that it does not intend to require the Company to redeem the Special Share. The Special Share, which may only be held by HM Government, does not carry any rights to vote at general meetings, but does entitle the holder to receive notice of, attend and speak at such meetings. Certain matters, in particular the alteration of specified Articles of Association of the Company, including the article relating to limitations which prevent a person from owning or having an interest in 15% or more of BT's voting shares and the article requiring BT's executive Chairman to be a British citizen, require the written consent of the holder of the Special Share.

HM Government, as holder of the Special Share, does not have a right to appoint or nominate Directors of the Company.

HM Government owns series of BT bonds with a total face value of £538 million that are presented in the balance sheet as of March 31, 1996 at a value of £496 million. The bonds are repayable at various dates between March 31, 1997 and March 31, 2004.

Commercial and other relations with HM Government

HM Government collectively is BT's largest customer, but the provision of services to any one department or agency of HM Government does not comprise a material proportion of BT's revenues. Except as described below, the commercial relationship between BT as supplier and HM Government as customer has been on a normal customer and supplier basis.

BT can be required by law to do certain things and to provide certain services for HM Government. The License obliges BT to provide certain services for HM Government departments, such as priority repair of certain telephone lines. In addition, the Secretary of State has statutory powers to require BT to take certain actions in the interests of national security, international relations and the detection of crime.

See "Regulation, competition and prices" with respect to the powers of HM Government and the Director General to regulate telecommunications within the United Kingdom.

Promoting Competition in Services over Telecommunication Networks

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Promoting Competition in Services over Telecommunications Networks

CHAPTER 4: ISSUES ON WHICH OFTEL IS NOT PROPOSING MAJOR CHANGE

4.1 Paragraph 2.1 listed the issues on which OFTEL has received representations in favour of change. This chapter deals with those areas in which OFTEL is not proposing significant changes although paragraphs 4.10 to 4.13 propose a clarification of policy on Relevant Connectable System status.

Structural separation

4.2 Some commentators argue that the only way to achieve fair competition in the network and enhanced services market is for BT's activities in each of these areas to be put into separate ownership. OFTEL is not proposing to pursue this option now because:

- * Many enhanced services are closely connected to the provision of network services. In practice, it could be difficult to separate the assets used in both activities - and any such separation could involve a high degree of cross selling;
- * OFTEL has always considered there to be benefits from the integration of network and enhanced services arising from the sharing of different facilities (economies of scope). These advantages are likely to benefit the customer as long as regulatory controls on abuse of dominance including accounting separation and the prohibitions on unfair cross subsidy and undue discrimination enable fair competition in the market.

4.3 OFTEL believes that - with BT's cooperation - it should be possible to make the regulatory controls on BT's behaviour work. If this should prove not to be the case, OFTEL would look again at the case for separation of BT's businesses.

Unfair cross subsidy and undue discrimination issues

4.4 These are significant issues given BT's vertical integration across the market for basic retail and enhanced services and its very large share of the network services market. As described in paragraph 3.27 there is a regulatory framework already in place to deal with unfair cross subsidy and undue discrimination issues.

4.5 The anti-competitive practices condition proposed in OFTEL's December 1995 consultative document "Fair Trading in Telecommunications", if implemented, would also have a role to play. The proposed condition would prohibit behaviour preventing, restricting or distorting competition in relation to any commercial activity connected with telecommunications. This includes both an abuse of a dominant position and the entry into any agreement with a competitor or a customer which has an adverse effect on competition. OFTEL has published draft guidelines which it would

propose to adopt if the condition is agreed. These guidelines specifically cover the question of unfair cross subsidy and undue discrimination (see pages 38 and 47-51 of "Fair Trading in Telecommunications"). OFTEL could also deploy Conditions 18 and 20B of BT's licence in relation to unfair cross subsidies by BT, if appropriate. The guidelines would be kept under continual review in the light of enforcement action and relevant case law. OFTEL is reviewing its enforcement procedures to increase the transparency and understanding of them. The outcomes of investigations will be made known on a regular basis, along with the reasons underlying them. An internal administrative casework audit system will be introduced to enhance procedural fairness.

4.6 OFTEL's view is that no additional regulation is needed to deal with questions of unfair cross subsidy or undue discrimination.

Should independent service providers be charged the same as network operators?

4.7 Some of those commenting on OFTEL's December 1994 consultative document argued that all independent service providers ought to have Relevant Connectable System (RCS) status which confers the following benefits:

- * Condition 13 charges;
- * ability to connect a wider variety of equipment to BT's network and to connect at C7 signalling interfaces which provides access to a wider range of services within BT's network; and
- * allocation of numbers, in their own right, rather than being limited to a sub-allocation of numbers through another operator.

4.8 Giving RCS status to independent service providers would mean they were charged the same for end-to-end network services as network operators are for network interconnection services. This has some attractions, not least because it would be deregulatory. However OFTEL is not proposing to adopt this approach for the following reasons:

1. the Condition 13 charges available to network operators reflect their usage of BT's network. Unlike service providers who require service across BT's network, network operators are connecting within BT's network and are charged only for the elements of the network they use and not for the costs of providing basic retail services. This will remain the case under the network charge control proposed in OFTEL's consultative document "Pricing of telecommunications services from 1997";
2. to allow connection of a wider range of equipment or connection at C7 signalling interfaces (that is, at non "network termination points") raises questions about ensuring that the particular equipment or connection will not lead to technical failures within BT's network. Before all service providers could be given such access, an appropriate mechanism would need to be in place to ensure the network was not put at risk;
3. if independent service providers offering a resale service substituting for BT traffic were charged for end-to-end network

services at Condition 13 rates, BT could find it was at risk of not covering all the costs of providing end users with access to the network. These access costs are currently met in part from call charges. If the access costs were not being covered, BT would be under pressure to increase this element of its charges.

4.9 Given the regulatory structure described at paragraphs 3.27 and 3.28, the consequence of independent service providers not getting Condition 13 charges for end-to-end network services is that they will continue to be charged retail prices for basic retail services (including end-to-end network services). This means they may find it harder to compete with BT in the provision of basic retail services although they would be paying the same as BT's Supplemental Services Business for basic retail services as an input to enhanced services.

OFTEL would welcome views on its conclusion that independent service providers should not get access to BT's network on the same basis as network operators for network services.

Future policy on Relevant Connectable System (RCS) status

4.10 The conditions surrounding RCS status are described in the glossary. It entitles the holder to Condition 13. The Director General can determine that a company should not have RCS status. There are one or two independent service providers who have RCS status and who are therefore currently benefitting from Condition 13 charges for the use of BT's network without having any network of their own. OFTEL would not propose to deprive any licensee who currently has RCS status of this. However, subject to the results of this consultation paper, OFTEL would propose to limit RCS status for anyone applying for an individual licence after 5 February 1996 (the date of publication of this paper) to:

- * network operators;
- * International Simple Resale (ISR) operators who are contributing significantly to competition in the international market.

4.11 The second category is because, at the moment, only two companies - BT and Mercury - have full international facilities licences. An ISR licence is therefore the only route for network operators to compete in the international market. Moreover most ISR operators have invested in some network (usually switching) facilities. OFTEL recognises that this policy would involve it in judgemental decisions about who should have RCS status. Developments in the EU mean that further international facilities licences may be granted in the UK in due course. When this occurs, OFTEL would propose to define as network operators only those building significant networks of their own.

4.12 OFTEL's proposed policy would mean that, in the future, service providers applying for licences (such as, for example, those offering personal numbering services) but not building their own network would not get RCS status though they would benefit from the changes proposed in Chapters 5 and 6 to the regulatory regime for independent service providers.

4.13 OFTEL recognises this could lead to questions about access to numbers and higher levels of interconnection with BT's network. There is no fundamental reason why providers of enhanced

services should not have access to numbering resources in their own right, provided the class licence(s) under which they operate required them to comply with the UK's specified numbering scheme and numbering conventions. OFTEL will be examining these issues as outlined in paragraph 2.2 with a view to putting forward further proposals on them as soon as possible.

OFTEL would welcome comments on its proposed future approach on RCS status.

Effects of current regulation on BT

4.14 Paragraphs 1.27 and 1.28 and the diagram at Annex A show that:

- * BT must charge the SSB and independent service providers the same price for basic retail services, although it charges itself Condition 13 charges for the network services that are inputs to those basic retail services;
- * BT charges other network operator Condition 13 charges for all network interconnection services whether those other network operators use them as inputs to basic retail services or enhanced services.

4.15 BT believes these arrangements already confer a competitive advantage on network operators and that this advantage will increase as the market in enhanced services develops.

4.16 There are two possible remedies:

1. BT charges the SSB Condition 13 charges for network services. But this would mean that competition from independent service providers would not develop unless they too had Condition 13 charges. The arguments against independent service providers having Condition 13 charges have been set out in paragraph 4.8;
2. Other network operators are forced to charge themselves retail prices for network services used as inputs for enhanced services. This would probably mean accounting separation and rules on transfer charges similar to those in BT's licence for all network operators, regardless of market position.

4.17 OFTEL does not favour the solution at paragraph 4.16(b). It believes the appropriate solution is a new independent service provider price or prices, the details of which are explored in Chapter 5.

INTERCONNECTION

BT'S RESPONSE TO OFTEL'S EFFECTIVE COMPETITION: FRAMEWORK FOR ACTION

CHAPTER 2

Introduction

1. Interconnection is a service which BT provides to, and buys from, its operator customers in the UK. Unlike most customer supplier relations, interconnection has an especial sensitivity since both suppliers and purchasers are also competitors. Fair interconnection arrangements lie at the heart of effective telecommunications competition. If interconnection charges are set too high, competitors would be unable to achieve realistic retail margins. If they are artificially low, there would be little network competition because operators would find it cheaper simply to buy services from BT rather than build their own networks. In the UK, the development of a standard portfolio of services and prices under the Interconnection and Accounting Separation (ICAS) programme, the benefits of which have yet to be fully felt, is going a long way towards achieving visibly and objectively fair interconnection charges.

2. Chapter 2 of OFTEL's statement "Effective Competition: Framework for Action" raises the possibility of further fundamental changes to interconnection arrangements from 1997. We are happy to contribute to this debate, but believe that the regime post 1997 need not be decided in haste, and should reflect and be consistent with pending European Union Directives. Our comments on the key issues of the Statement follow.

Barriers to Entry and Extent of Competition

3. BT supports OFTEL's conclusion that interconnect charges should not be used to subsidise competitors. We also welcome OFTEL's view that any potential incentive regulation aimed at promoting effective competition should be kept entirely separate from actual interconnection price levels.

4. BT welcomes competition and believes that fair interconnection prices allow sustainable and efficient entry. Subsidised prices promote inefficient entry and can deter or undermine investment in competing infrastructure. We agree that clearly identified barriers to entry should be dealt with directly rather than through adjustment to interconnection prices. Barriers to entry are characteristic of most markets and their existence does not necessarily signal a wrong, or a case for subsidy. In any case, such barriers have not prevented market entry on a scale unparalleled world-wide. The UK market for telecommunications has now passed beyond the entry stage.

Consolidation is now underway, particularly in the Cable TV sector. Such consolidation, along with the fact that there will always be winners and losers where true competition exists, is a natural part of sustainable competition and the signs are that we are quickly moving to an effective, competitive market. We acknowledge that large investments are often necessary to become an

effective player in the telecommunications industry, but existing and potential competitors are increasingly global companies who are well placed to support such investment. In addition, we have seen operators from other industries using economies of scope to provide services over a common infrastructure.

5. BT believes that the industry would benefit from far more explicit definitions from OFTEL on barriers to entry and "effective" competition, including the criteria to be used to measure the extent to this competition and to judge when it has become "effective". Simple fixed "exchange line share" measures, for example, are one of many market measure and do not give a true picture of market power, especially given the existence of indirect access, resellers and value-added suppliers, and the substitutional effects of mobile services. Nor should market power be measured at the national level. There are market sub-sets for mobile services or services to major customers, for example, which are the particular focus of new entrants and where BT is far from possessing market power. Regulation should be lifted progressively; there are already market sub-sets where that process should begin.

Incremental Costs and Mark-Ups

6. BT recognises that there are theoretical grounds for the use of Long Run Incremental Costs (LRIC) as a basis for interconnection pricing and notes that OFTEL proposes to use the output from the ICAS Task 19 cross-industry group currently working on this issue. All indications from this group are that there are considerable practical problems with LRIC, not least of which is that they are very difficult to calculate. "Bottom-Up" engineering-based models, for example, often underestimate the "true" costs of a business and incremental costs in general would not reconcile to audited figures, thereby eroding confidence in their veracity. A "top down" approach based on BT overall results, would ensure that prices were based upon real costs incurred rather than a theoretical model. This approach is also more likely to capture full costs to a greater degree of accuracy.

7. Any departure from charges based on costs incurred in practice represents a subsidy, either to BT, if the actual charge is greater than cost, or the other operator, if the charge is lower. As we have previously shown, subsidy distorts both market entry and market behaviour, at a cost to efficiency.

8. For these reasons, BT believes that any LRIC regime should be based on "top down" costs. We note that other operators tend to favour the "bottom up" approach (para. 2.15 of the Statement). This preference is, no doubt, based on the belief that such an approach will yield the lowest charge. But it is doubtful whether the use of a charge based on a theoretical LRIC would product market benefits. It could make BT prices among the keenest available, leaving those investing in capacity to act as a carrier's carrier badly stranded. Operators would buy from BT instead of building networks of their own, thereby undermining infrastructure competition. These make or buy decisions would be based not on comparative efficiencies but on the difference between the actual costs of alternatives and BT's theoretical costs, a situation which could unduly penalise efficient operators.

9. In the Statement, OFTEL proposes to allow BT to recover its fixed and common costs by applying mark-ups which would be equal across all types of service. This method has been chosen chiefly for its simplicity, but this benefit - and it is hard to see any others - is far outweighed by the lack of economic logic and the subsequent market distortions that would result from an equal mark-ups regime.

10. Under an equal mark-up regime, no account is taken of the relative elasticities of various services. This would mean that retail prices came to reflect the interconnection regime rather than the elasticities of the retail markets. In addition, there needs to be consistent treatment across the Access, Network and Retail areas. OFTEL's proposals would lead to the Network account not bearing its full costs, which leads to more costs being borne by Retail, a position which distorts end user prices and creates false competitive positions.

11. Given OFTEL's intent (para 2.67 of the statement) "better to reflect the basis on which business decisions are made", then the optimal way of achieving this is to adopt a mark-up regime that reflects the elasticities of a competitive market. BT should be allowed to make its own business decisions, as it is best placed to judge the relative elasticities of its product portfolio. BT needs to recover fixed and common costs in an economically efficient way that sends the right make and buys signals to other operators. A mark-up approach that reflected elasticities would allow this whilst also encouraging efficient market entry, thus meeting OFTEL's stated objectives.

12. LRIC pricing may pose difficulties in its introduction but is clearly superior. Mark-ups based on elasticities are also hard to devise but yield greater benefits than the alternatives. If we are able to work through the difficulties of the former then we should be able to do the same for the latter. BT believes that moving to LRIC pricing without mark-ups based on elasticities would, in the long term, be more damaging to the development of the industry than staying with the interconnection regime that is now being implemented as part of the ICAS programme. The industry should either tackle LRIC and elasticity-based mark-ups together or leave them both alone.

Network Price Cap

13. BT recognises that a network price cap could offer some degree of certainty to the industry in general about trends in the level of interconnection charges. However, as an addition to current cap arrangements, a network price cap would represent an intensification of detailed regulation at a time when a withdrawal from regulatory involvement should be underway. One of the key considerations of a network price cap is the contribution it can make to simplifying and rendering less intrusive regulatory controls.

14. We welcome OFTEL's recognition of the implications for the Retail cap of this proposal, which reinforces the view that the Network and Retail issues should not be thought about in isolation. A price cap available to a basket of services should be designed to give the regulator overall control within certain limits whilst also allowing the operator a degree of flexibility, once again within the limits of the cap. Setting the initial level and slope of the cap will be a very sensitive exercise, since any under or over recovery of costs will impact relative shares and the nature of the market. The suggestion that certain services ("Call Termination Services") within the overall cap should still be subject to OFTEL determination or even a sub-cap is inconsistent with simplification of the regime, involving, as it would, further regulatory intervention in detailed pricing issues.

15. The concept of price caps in general has gained wide acceptance throughout the world, providing as it does inducements for efficiency and a relatively low cost of administration. Efficiency, too, should be the goal of the regulator and is of course frustrated by too heavy handed or detailed an approach.

16. Some form of cap, combining treatment of interconnection customers and retail customers may have a contribution to effective but efficient price regulation and merits further discussions and debate. Proposals developed by Laffont and Tirole suggest that a combined cap may be feasible. They show that it would not be in BT's own interests to discriminate against interconnecting operators in favour of itself in setting the prices of all services to recover its overall costs. Instead, the supply of interconnection services should be treated as any other service, with prices determined by Ramsey pricing rules according to the elasticities and cross-elasticities of demand. Any safeguards concerning non-discrimination or predation, for example, could still be developed within the framework of a combined price cap and could be withdrawn as market conditions permit. For these reasons, BT believes that the concept of a single comprehensive price cap, if accompanied by a lessening of regulation, may have much to offer and is consequently worthy of further consideration.

Burden of Proof & Efficiency Adjustment

17. In view of the fact that we are still in the process of adjusting to life under the ICAS regime, BT believes that, rather than introduce further changes at this stage, it would be more beneficial to everyone to work with the new arrangements for the present and for OFTEL, as it proposes, to keep this area under review. We note also that an efficiency adjustment to interconnection charges generally (which we do not accept is merited) would have the adverse effects for competition described in para. 8 above.

Conclusion

18. As we stated in the beginning of this response, we believe that the UK has already gone a long way to achieving fair and effective competition in the telecommunications market. Whilst there is clearly still some way to go to achieving fully effective competition, it should not be overlooked that conveyance rates have fallen dramatically over the past years. The table below illustrates the rate at which average rates have dropped since 1985/6.

Call Segment 1985/6 base 1995/6
Local 100 41.8
Short National 100 23.6
Long National 100 26.4
Average 100 29.1

In addition, according to a recent Ovum report, conveyance prices in the UK are already amongst the lowest in the world.

19. OFTEL has the opportunity to move towards a more market-driven environment which, whilst still protecting competitors, would give BT the scope to develop into a genuinely commercial operator to the benefit of customers and industry alike.

PRICING OF TELECOMMUNICATIONS SERVICES FROM 1997

OFTEL's Proposals for Price Control and Fair Trading

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PRICING OF TELECOMMUNICATIONS SERVICES FROM 1997:
OFTEL's Proposals for Price Control and Fair Trading

CHAPTER 2: OVERVIEW

THE MARKET

2.1 The price control proposals set out here for formal consultation have to be measured against the market in which they will be operating. The UK telecoms market is the most open and competitive in the world. BT already faces strong competition from a great many operators active in different sectors. The industry is innovative and dynamic and will undoubtedly see many changes during the period of the next price control. Advances in technology will bring new products and services. BT and other operators will be competing not just on the price of the services they can deliver but on the breadth of choice they offer and the quality and efficiency of their services. There will be a continuing rapid development of competition over the period of the next price control. Competitors will not just be nibbling at BT's market but will be firmly established as a rival force. Indeed, both BT and other operators seem to share the view that BT's market share of calls at the end of the period could be around 60-65% as against 80% now. And it will be a bigger market. OFTEL sees continuing sustained growth in the markets for both price-controlled and other services.

2.2 It has been a constant theme in all recent OFTEL consultation documents that regulation is a poor substitute for the operation of an effectively competitive market. OFTEL has made clear that its aim is to pull back from regulation as competition advances and to ensure that remaining rules match the market. Rules must not hinder the development of new services which innovation and the convergence of different parts of the telecoms industry and of the telecoms, broadcasting and IT industries will bring.

2.3 BT will go into the next price control period as a very powerful, dominant player in most segments of the UK telecoms market. It will have close to 90% of all exchange lines. In the second consultative document on price control OFTEL set out its views on the level of competition expected in different market segments in the period ahead. In some segments competition will be fully effective, or nearly, and will itself provide protection to consumers against undue price increases. In other parts of the market, particularly for residential customers, it will not.

2.4 OFTEL reaffirmed in the second consultative document that its objectives for the price control review were to continue to provide protection for the customer where competition was not yet effective; and to ensure that BT continued to seek efficiency improvements at least as great as other world-leading communications companies. OFTEL is not seeking to further its objective of promoting network competition through this review: it is addressing that through other measures. Equally however, OFTEL does not want the outcome of the review to slow the development of competition. It has, therefore, had regard to the impact of its conclusions on the

capital markets' and companies' ability to fund existing investment commitments and their willingness to continue to see the UK as an attractive, growing advanced market in which their companies must be active.

FAIR TRADING

2.5 Up to now regulation of BT has for the most part taken the form of detailed prescriptive controls on its behaviour. In an increasingly competitive market this is less and less appropriate. It is impossible to predict exactly how the UK telecoms market will develop in the future and how competitive forces will shape it. The particular competition issues which OFTEL will need to address in the future cannot be known. Seeking to deal with anti-competitive behaviour by BT or other operators through detailed conditions in their licences which address issues seen as problems today will, therefore, almost certainly not address the important problems relevant to the markets of tomorrow.

2.6 OFTEL considers that with increasing competition in the industry it is now appropriate to introduce a package of measures that constitute a major step towards deregulation:

- * a large reduction in the range of BT's activities which are subject to price controls;
- * much greater pricing freedom for BT for activities which remain subject to price controls;
- * the introduction of a licence condition on anti-competitive behaviour; and
- * the deletion, in whole or part, of 15 detailed conditions in BT's licence.

By this package of measures, OFTEL would take a large step away from being a detailed, prescriptive monopoly regulator towards being a fair trading authority. Competition, rather than OFTEL, would increasingly become the industry regulator. But this can only be done if, as part of the package, OFTEL has effective powers to ensure that conditions for fair trading are not undermined by anti-competitive behaviour.

2.7 OFTEL believes that a framework of fair trading rules based on Articles 85 and 86 of the EC Treaty is the best way to address competition issues in telecoms in the future. The Government in its recent consultation document on future competition legislation is proposing that whether the terms of Article 85 should be adopted in general domestic competition law. This may lead to change - but obviously this can't be assumed. In the meantime, therefore, OFTEL has had to consider what measures are necessary within the current framework of competition law and within the scope of the Telecommunications Act 1984.

2.8 OFTEL has been consulting on how to address anti-competitive practices for some time now (the first consultation was in December 1994). The price control review has, however, brought this issue into sharper focus: the proposed new price control arrangements from 1997 at both retail and network levels would give BT much more pricing flexibility than it has had previously. Under the proposals here only 26% of BT's group revenues would be subject to retail

price caps as against 64% now. At the network level, only 40% of charges would be capped and a further 20% would be subject only to safeguard controls. More importantly BT will have much greater freedom to set retail prices and the network charges which other operators pay for use of BT's network. These must be fairly set. OFTEL needs effective powers to police these new arrangements and to act swiftly if BT is abusing its flexibility to the detriment of its competitors or of consumers.

2.9 OFTEL's concerns about anti-competitive behaviour are not however, confined to price control but are driven by broader considerations about the nature of the future market. Indeed OFTEL's concerns are not solely with potential anti-competitive behaviour by BT but with that of any operator with market power. That is why OFTEL is proposing that a Fair Trading condition - a general prohibition on anti-competitive behaviour - should be introduced into all operators' licences.

2.10 Chapter 3 here discusses the responses to the consultative document on the Fair Trading Condition which was published in December 1995 and sets out OFTEL's firm proposals.

2.11 The responses to the consultation have generally been supportive of OFTEL's approach. BT and a few respondents, however, objected that the scope of the condition was so wide that there should be a right of appeal to some other body on the substance of any decision taken by the Director General. After careful consideration of all the arguments and an analysis of the practical implications of such an approach, OFTEL has concluded that it cannot within the current legal framework, introduce an appeal mechanism, beyond what is already available under judicial review; and that its proposals strike a fair balance between a dominant company, its competitors and their customers.

PRICE CONTROL

Retail

2.12 OFTEL is confident that at the retail level effective competition is not far away and that the retail price control arrangements proposed here will be the last. The second consultative document on price control concluded that, while there are good prospects for competition in certain services and for medium and large businesses, there would not be effective competition for most residential customers and small businesses for any service until there is effective competition to BT from local access operators. Cable companies' networks are expanding rapidly and they are taking on many new customers. Ionica, the new radio-based operator, launched its service in May. Competition is building up but there will not be effective competition in the local access market at the start of the next price control period in August 1997. The document therefore set out three options for future price control:

- * a standard four-year price cap covering roughly the same services as now and all customers.

Or alternatives which sought to reflect increasing competition in the market:

A two-year price cap with a review in 1998 of whether further controls were needed.

Price control covering the same services but focused on the residential and small business sectors of the market.

2.13 OFTEL has decided to pursue the residential/small business option which gained considerable support in the responses to consultation from a wide range of opinion, notably from the Consumers Association and the National Consumer Council. OFTEL considers that those customers most in need of continuing formal price control protection are the low to medium spending residential customers and small businesses who have similar spending patterns. Four million high spending residential customers, the top 20% by bill size, spend very much more per head than the other 80% on national and international calls. They are highly profitable and there is strong competition for their business from competing local access suppliers and indirect operators. BT will want to keep them and to offer tariffs that are attractive to them. They, therefore, don't need the full weight of formal price cap protection. Indeed, including them in a price cap increases the incentive on BT to focus price cuts on these customers (perhaps by bigger reductions in national and international call charges) rather than on services which are used more heavily by lower-spending consumers, who represent the bulk of the population.

2.14 OFTEL's proposals are, therefore, that there should be a formal price cap covering those services currently controlled (apart from Directory Enquiries where OFTEL is investigating separately the prospects for introducing competitive supply) but applied to the residential market only. In order to focus the price controls on the low to medium spending customers, the formal price cap would be applied using only the revenues and calling patterns of the first 80% of residential customers by bill size. OFTEL expects, however, the benefits of price control will extend to all residential customers. BT has indicated that it is moving to introduce a range of call/line rental pricing packages to offer more choice to its customers. Packages will be designed to be attractive to both high users (eg high rental charges/low call prices) and to low users (eg lower rentals but higher call charges). OFTEL has discussed with BT what assurances BT would give, as part of the new price control arrangements, on the effects on bills for customers spending below the average. BT will need to consider this further in the light of these formal proposals.

The Director General, however, expects BT to offer an assurance that no-one's bill (for the same usage) will increase by more than RPI over the period. For high spending residential customers not covered by the formal price cap, OFTEL expects that BT will want to introduce packages which will give them reductions in prices at least as good as those required by the cap in order to meet competition for these customers from other operators, including indirect access operators.

2.15 OFTEL would ensure that small businesses benefit from price control reductions by requiring BT to offer a package for business customers which would provide call charges no higher than those used for calculating adherence to price control in the residential market and line rental increases of no more than RPI per year. The 'control' package would be available to any business customer. BT would be free to offer a better deal if it chose to or competition might require it to do so. This 'control' package would probably be only one of several packages BT would be offering to business users. Other packages with higher rental and lower call charges would be attractive to businesses with significant call volumes. Apart from the requirement for a 'control' package there would be no other formal price controls on BT's services to the business market. The existing requirements on BT not to discriminate unduly or to cross-subsidise

unfairly and the provisions of the new Fair Trading condition would, of course, apply to ensure BT did not use its pricing freedom here anti-competitively.

2.16 X for the proposed residential cap would be 4.5%. This cannot be compared directly with the 5-9 range for X which OFTEL set out in the second consultative document. That range applied to a price cap covering all currently regulated services and all customers. OFTEL's final proposal for the residential cap is equivalent to 7-8.5% on this basis. X for a residential cap is smaller (as explained in the second consultative document and in the subsequent note which OFTEL circulated) because residential customers make fewer international and national calls than businesses. These calls have high levels of profit and so taking them out of the control reduces the value of X. In fact, in the past, because BT has concentrated price cuts on business users and high spending residential customers, the effective X for the first 80% of residential customers in terms of price cuts derived has over the last six years actually been only 2.7% when the headline X's was 6.25% and 7.5%. An X of 4.5% for a residential basket for 1997-2001 will, therefore, ensure that lower spending residential customers are assured greater protection than before. These proposals are good news for residential and small business customers. Competition will ensure that there is good news for other business customers too.

2.17 Chapter 5 sets out what action OFTEL has taken on ISDN connection charges and calls to mobile. Both issues are being pursued urgently but separately from the price control proposals and OFTEL does not presently propose that they should be part of the price control package from August 1997. OFTEL expects to see further developments on both these issues in the next few weeks and will make public its response to them. The availability and affordability of public payphones will be pursued as part of OFTEL's current review of universal service. This is not something OFTEL will address in the price control package. Chapter 5 also sets out action BT has agreed on hard-wired telephones.

Network Controls

2.18 OFTEL intends to press ahead with its proposals to introduce network charge caps and a framework of interconnection charges based on incremental costs. It intends that these new arrangements will be in place by August 1997. It is not, however, consulting here on final draft licence modifications nor setting the starting basis for the network caps. Further discussion is needed with the industry about the details of the proposed changes to ensure that the methodology is well understood. It is better that starting values for the new controls should be set nearer the time in the light of more up to date figures.

2.19 Chapter 4 sets out OFTEL's latest thinking and latest indicative figures for costs which will form the starting basis for the caps. OFTEL will consult further on the draft licence modifications included here, with a view to putting forward final proposals for statutory consultation towards the end of the financial year in the light of the most up-to-date cost information. If BT accepts them the new arrangements would be put into operation by August 1997. If it doesn't, then the issue will be referred to the Monopolies and Mergers Commission and the present arrangements for setting charges will continue in the interim. Delaying firm proposals for interconnection arrangements does not affect OFTEL's proposals for the retail cap.

DE-REGULATORY ASPECTS OF PRICE CONTROL PROPOSALS

2.20 In the retail market there will be no price controls on the business market other than the requirement to offer a small business 'control' package. This allows BT a lot of scope in pricing to meet competition in this important sector.

2.21 At the moment OFTEL determines each year most of BT's interconnection charges. In future, when the new interconnection arrangements are in place, BT will be free to set its own charges, subject to the requirements of the network caps and within an indicative framework of floors and ceilings related to incremental and stand alone costs respectively. This will give BT considerably more flexibility than it has now in setting charges and, in OFTEL's view, it will be a move towards pricing arrangements appropriate to a competitive market. Any flexibility can of course be abused: BT could, for example, seek to increase charges for services (and for network components within services) which BT itself uses less frequently than other operators and at the same time to lower retail prices for services using these network components, thus squeezing operators' margins.

2.22 OFTEL can only offer BT the flexibility inherent in these price control proposals if it is confident that it has powers to deal effectively and quickly with potential abuses of market power. This is why OFTEL sees BT's acceptance of the Fair Trading condition as a pre-requisite for agreement to the proposals. BT cannot accept one without the other. The proposals are an indivisible package.

2.23 If OFTEL does not have the powers necessary to deal quickly with anti-competitive behaviour then it would bring forward very different price control proposals. This would probably mean reverting to its present detailed determination of network charges and reconsidering its decision to remove most of the business market from formal price control (but retaining residential and small business protection). This can only delay the arrival of a properly competitive market-place in which competing operators take business decisions on pricing against a background of broad competition policy safeguards rather than continuing to rely on detailed regulatory rules.

2.24 OFTEL hopes that BT will accept this package of price control and fair trading proposals as a significant step forward to the competitive market-place which it, other operators, consumers and OFTEL wish to see developing rapidly in the years ahead.

PRICING OF TELECOMMUNICATIONS SERVICES FROM 1997:
OFTEL's Proposals for Price Control and Fair Trading

CHAPTER 4: NETWORK CHARGE CONTROLS

INTRODUCTION

4.1 In the first and second price control consultative documents OFTEL set out its proposals for future interconnection charging arrangements. OFTEL proposes to replace the annual determination of charges with a system of network controls for those services which are not competitive, using baskets of interconnection services, each subject to a charge cap formula of $RPI-X$. Charges for those services which are expected to become competitive during the next control period will not be included in the network baskets, but will be governed by safeguard caps of $RPI+0\%$. Charges for those services which are expected to become competitive before August 1997 will be free of network controls.

4.2 This chapter sets out OFTEL's proposals for future network charge controls, following its careful consideration of the responses to the first and second consultative documents. OFTEL intends to press ahead to put the new arrangements in place by August 1997. However, OFTEL has decided not to try to set firm figures for the starting level of the network baskets and the values of X at this stage. It will be more appropriate to set these nearer the start date of the new controls, using much more up to date cost information than is currently available. Moreover, OFTEL is very conscious of the concern in the industry that the incremental cost work, on which OFTEL proposes to set the cost base for the network baskets, is not yet sufficiently well understood or visible. With the exception of these figures, the detail of OFTEL's proposals for network controls is set out in this chapter, and the draft licence modifications to put these proposals into effect from 1 August 1997 are attached at Annex D. These licence modifications are still drafts for informal consultation - they represent a further stage of consultation before the statutory consultation, and OFTEL would welcome comments on its proposals.

4.3 OFTEL will be discussing the implementation of the new interconnection framework with the industry in the coming months. OFTEL proposes to produce firm figures for the starting levels of the baskets and values of X early in 1997. At that time, licence modifications, including these figures, will be put out for statutory consultation. If BT agrees to the modifications, the network controls will commence on 1 August 1997. If BT were to fail to agree, there would be a reference to the Monopolies and Mergers Commission (MMC) and the introduction of the network controls will be delayed. In such circumstances, before licence modifications were resolved following the outcome of the MMC reference, the current interconnection regime involving determinations of charges by the Director General would continue.

Starting levels for the network baskets

4.4 OFTEL had intended to produce the starting levels of the network baskets for this document by taking the outcome of the reconciliation of the incremental cost models and forecasting these figures forward to derive the 'unit costs' of interconnection services in the baskets at 1 August 1997 (in this context, unit cost means incremental cost plus equal proportionate mark-up). The top-down and bottom-up incremental cost models have now been reconciled and hybrid figures that draw upon both models have been produced for 1993/94 and 1994/95. The reconciliation has largely been successful, in that material differences between the results of the top-down and bottom-up models at the level of switching and transmission can be accounted for. The incremental cost figures derived for these years are therefore soundly based. However, when comparisons are made between the models at a more disaggregated level, some issues of comparability arise, for example, because the network components are classified differently in the two models. Both of the models could benefit from further development and refinement, which could improve the robustness of the incremental cost figures and allow a more complete reconciliation at a disaggregated level to be carried out.

4.5 The figures in the bottom-up model relate only to 1993/94; there are versions of the top-down model for both 1993/94 and 1994/95. Delaying the production of figures for the starting levels of the caps will enable OFTEL to base its analysis on further and much more up-to-date cost information. The timing of the financial reporting cycle will mean that versions of the top-down and bottom-up models can be produced using information for the full year 1995/96, and the interim figures for the first half of 1996/97. The incremental cost models will therefore be available over a series of years and a more robust picture of how incremental costs can be expected to move over time will be built up. By delaying the announcement of the starting levels of the network baskets until significantly closer to August 1997, OFTEL's analysis will be built upon a much firmer base of cost information and the risk of forecasting error will be reduced.

4.6 The remainder of this chapter sets out in detail the structure of the network controls that OFTEL proposes should be implemented on 1 August 1997. After an introductory section, the classification of interconnection services by degree of competitiveness is set out, including the proposed regulatory treatment for each category. The mechanics of the starting level for each basket (the 'allowable revenue') is then explained, although as discussed above, the values of the units costs that make up the allowable revenues, and the final values of X for the network baskets, are not set out in this document, but will be produced early next year. In the next section the proposed rules and guidelines affecting the flexibility that BT will have to set charges within the new regime are discussed. Thereafter OFTEL's position on charges for call termination on other operators' networks, and on the interaction between network and retail caps is confirmed. The chapter concludes with an introduction to the draft licence modifications for the network controls, which are attached at Annex D.

SIMILARITIES TO AND DIFFERENCES FROM THE CURRENT REGIME

Features of the current regime that will remain

4.7 As emphasised in the first and second consultative documents, many features of the current interconnection regime will remain in the proposed new regime. For example, there will continue to be: publication of separate, audited accounts for BT's regulatory businesses and disaggregated